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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1930.

No. 521.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

EDITH ANDREWS LOGAN.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR RESPONDENT.

MILLARD F. TOMPKINS,
HERBERT C. SMYTH,
New York, New York,
JOHN ENRIETTO,
Washington, D. C.,
Attorneys for Respondent.

Of Counsel,
JOHN W. FORD,
Youngstown, Ohio.

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On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

BRIEF FOR RESPONDENT.

The opinion of the United States Circuit Court of Appeals for the Second Circuit (R. 94–99), unanimously reversing the order of the United States Board of Tax Appeals (R. 33) is reported in 42 Fed. (2d) 193. The opinion of the Board of Tax Appeals, (R. 20–31), two members dissenting in part (R. 32), is reported in 12 B. T. A. 586. This opinion overruled, in part, a prior opinion of the Board of Tax Appeals in a case involving the same contract (Appeal of *Julia Andrews Bruce*, 5 B. T. A. 300). The opinion of the United States Circuit Court of Appeals for the Sixth Circuit, in the case of another taxpayer involving the transaction under consideration here is reported in *Hitchcock* v. *Com'r*, 44 Fed. (2d) 756, now pending on petition for rehearing.

The basis for jurisdiction in this Court is correctly stated in petitioner's brief.

Questions Presented.

Petitioner's statement of the question is confusing. Additional income taxes are asserted for the years 1918, 1919 and 1920. The questions presented are:

(1) Respondent in 1916 sold shares of stock for a cash payment and a promise by the purchaser to make further payments per ton, as, if, and when it received iron ore from a certain mine. The aggregate payments made up to December 31, 1920, were stipulated to be less than the March 1, 1913, value of the stock sold. Were any of the payments taxable as income?

(2) Respondent inherited in 1917 the right to receive similar payments from the purchaser on account of stock sold by her mother in 1916. The value of this inherited right was taxed by petitioner as part of her mother's gross estate. It was stipulated that the payments received by respondent up to December 31, 1920, were less than the amount at which petitioner taxed this inherited right as part of the estate. Were any of the payments taxable as income of respondent?

(3) Assuming, but not conceding, that any portion of the payments received by the respondent can be treated as income, was the Commissioner right in holding that 66.901% of each payment received by bequest, and 67.446% of each payment received during the taxable years in question from the sale, were taxable income?

Statement of Case.

On March 11, 1916, respondent sold to the Younsgtown Sheet & Tube Company, under a written contract, 250 shares of stock of the Andrews & Hitchcock Iron Company (R. 97-108), which she had acquired prior to March 1, 1913. The Andrews Company, an Ohio corporation, had a total outstanding capitalization of 4,000 shares. All of its stockholders were parties to the contract of March 11, 1916, and

under it sold their respective stockholdings. Mrs. Louisa Andrews, respondent's mother, a party to this contract, under it sold 1180 shares of the same stock, which had also been acquired by her prior to March 1, 1913 (Agreed Statement, R. 44).

At the time of the sale, the Andrews Company owned certain physical assets consisting of land, buildings and equipment (R. 61), and in addition 12 per cent of the capital stock of the Mahoning Ore & Steel Company, a Pennsylvania corporation, which was the lessee for 97 years from April 1, 1895, of certain mineral lands in the Mesaba Range of Minnesota (Agreed Statement, R. 44).

A 50 per cent interest in the Mahoning stock was held by the Cambria Iron Company. The balance of its stock was owned by other steel companies (R. 50). All the Mahoning stockholders, by contract dated December 16, 1914, had agreed as follows:

1. That the Board of Directors of the Mahoning Company should fix on or before April 1st, of each year, the annual tonnage of iron ore to be produced;

2. That each stockholder would be entitled to take, if he wished, a full quota of each grade of iron ore produced annually, in proportion to the amount of stock owned;

3. That the price of said ore should be fixed each year by the Board of Directors at or about the cost of production, including all costs of transportation, delivery, etc., to the lower lake ports (R. 49-51).

Neither the selling stockholders of the Andrews Company, nor the purchaser, the Youngstown Company, could agree upon the cash value of the 12 per cent minority interest in the Mahoning Company (R. 61, 62). The contract of sale with the Youngstown Company provided that the selling Andrews Company stockholders should receive a down payment of $2,200,000 in cash, and, as and for the balance of the purchase price, the Youngstown Company agreed to take annually the full quota of iron ore to which the Andrews

Company would be entitled under the contract of December 16, 1914, and to pay annually to the selling stockholders 60 cents for each ton of ore so entitled to be taken, and actually delivered or left at the mine by direction of the Youngstown Company (R. 46-49).

Under this contract, respondent received down to and including the taxable year 1920, for the 250 shares of stock sold by her, the following sums (Agreed Statement, R. 45):

1916	-	$137,500.00,	respondent's proportionate share of the $2,200,000 down payment.
1917	-	9,900.00	
1918	-	11,250.00	
1919	-	8,995.50	
1920	-	5,444.30	
Total	-	$173,089.80	

and the government conceded that the aggregate of these payments was less than the March 1, 1913, value of the stock sold (Agreed Statement, R. 45).

The respondent reported her income for the years in question on the basis of cash receipts and disbursements (Agreed Statement, R. 45). She included no part of the payments received from the sale during these years as income (R. 7-11).

Respondent's mother died on March 22, 1917, and respondent acquired by inheritance from her a 550/4000ths interest in any subsequent payments that might be made by the Youngstown Company under its contract for the purchase of the Andrews Company stock. The value of this interest was fixed by the Commissioner of Internal Revenue for the purposes of the Federal Estate Tax imposed upon the estate of Louisa Andrews at the sum of $277,164.50 (Agreed Statement, R. 44). Mrs. Logan, as payment of this bequest, received during the years in question a total of $31,767.59 (Agreed Statement, R. 45). She reported none of it as income (R. 7-11).

From these facts, in more or less obscure language of "depletion," "royalties," "ore payments," and "income-producing contracts," the Commissioner drew the following conclusions (R. 53-60):

(1) The promise of the Youngstown Company to make these future payments was "property" received and had a "determinable and assignable fair market value" in 1916, and such interest ought to be regarded as equivalent to cash in the amount of $1,942,111.46 (R. 46). This "market value" is determined by making a series of assumptions and prophecies, and then applying Hoskold's formula. Taking *only* 620 out of the 1,000 acres of mineral land leased by the Mahoning Company, the Government engineers estimated the ore reserves in said 620 acres at 82,858,535 tons (R. 45, 88); assumed that the future average production of ore would be 1,841,300 tons per annum; assumed that all of the ore would be mined out in 45 years (R. 45), and that the Andrews Company would be entitled to take 12 per cent of the total ore, or 9,942,564.2 tons, which at 60 cents per ton would result in total estimated payments of $5,965,814.52 and then determined the *present worth* of that sum on the assumption that it would be received in equal annual instalments during 45 years by discounting it at 6 per cent, with provision for a sinking fund of 4 per cent. This gave a "market value" of $1,942,111.46 (R. 46).

(2) Having found that these future payments had a "market value," the Commissioner concluded that the transaction was a closed and completed transaction in 1916, giving rise to gain or loss in that year.

(3) The Commissioner then added his "market value" of $1,942,111.46 to the cash payment of $2,200,000, and found the sum to be less than the March 1, 1913, value of the stock sold, but greater than the cost of the stock sold, and therefore, so far as 1916 was concerned, no gain was derived, and no loss was sustained.

(4) The Commissioner then concluded that this disposed

of the March 1, 1913, value, and a new basis was established, to-wit, a contract right to future payments, which is "disposed" of or converted into possession by the receipt of cash in each year. This disposition or conversion, as and when it is made, results in derivation of income in part and in part constitutes the return of the value of the contract so disposed and converted, spread equally over the period in which it is assumed that payments will be made. The proportion is 32.554 per cent return of contract right, and 67.446 per cent income. The percentage of capital is determined by taking $1,942,111.46, "fair market value" of the contract right "sold or disposed of," and dividing it by the total amount that should eventually be received if all the assumptions prophesied by petitioner should become facts, to-wit, $5,965,814.52.

The proportion of "capital" in respect of the inherited payments was determined by dividing the value used for the Estate Tax levy by the total anticipated payments from that date, resulting in the conclusion that 33.099 per cent represented a return of inherited right and 66.901 per cent constituted gain or income.

(5) Treating the payments received by the taxpayer as royalties or "ore payments" subject to depletion (R. 7-11), instead of payments for stock sold, and payments on account of a bequest, the Commissioner proposed the deficiencies complained of on the above basis. The Board approved the determination (R. 13-33) on the same basis.

The Circuit Court of Appeals refused to find that it is necessary to go through such an intricate process to find a gain on the sale of stock. It held that there were so many uncertainties involved in the future receipt of the 60 cents a ton by the selling stockholders, and "ample testimony satisfactorily establishing that there was no market for the sale of the obligation to pay the 60 cents per ton for 45 years, and it had no cash equivalent," (R. 97); that, as respondent concededly never recouped the March 1, 1913,

value of the stock sold, or the value fixed for the bequest for the purpose of a Federal Estate Tax, no taxable income has been received by her (R. 94-99).

What is more, the Government suggests in this court, and for the first time, that the whole of the payments is taxable income and no part is a return of capital, but that it is satisfied not to disturb the prior determination. The Government contention comes to this: A taxpayer sells stock and receives part payment in cash. The Government concedes that the cash payment of $2,200,000 is *at least* $1,942,111.46 less than the March 1, 1913, value of the stock sold, but contends that every dollar after that first cash payment is taxable income.

SUMMARY OF ARGUMENT.

The contract of March 11, 1916, was a sale of stock and not an exchange of property for property, so that there is no taxable gain until the aggregate payments exceed the March 1, 1913, value of the stock. The fact that part of the payments for the stock is spread over the future years does not operate to exclude the March 1, 1913, value of the stock as the basis for computing gain. The Commissioner's determination deprives this taxpayer of the benefit of using the March 1, 1913, value as its basis. Before there is any taxable gain, the consideration must be received and must be cash or readily reducible to cash. The promise to pay cannot be considered the equivalent of cash nor can a present tax be based upon the expectation of future profit, or the determination of a paper profit, to a taxpayer reporting income on the cash receipts basis.

The existence of a fair market value for such a promise is a mixed question of law and fact on which the Board of Tax Appeals findings and conclusions are not binding. "Fair market value" for purposes of computing gain or

loss contemplates the existence of supply and demand and contemplates the receipt of a fair price for the property evaluated, and must be distinguished from the so-called intrinsic value, or the existence of some value.

The promise to pay in this case is so contingent, uncertain and indefinite that it cannot be considered the equivalent of cash or to have a "fair market value," and the finding of the court below to this effect is amply supported by the conceded facts and the evidence. The assumptions on which the Commissioner's determination is founded are clearly contrary to the evidence and are so far fictitious that they serve but to indicate the absence of any market value. The promise to make future payments, having no fair market value and not being the equivalent of cash, the value at March 1, 1913, of the stock sold is the proper basis for measuring taxable income, and the taxpayer is entitled to recoup that value before there is any realization of gain subject to income tax.

As to the interest in the payments bequeathed to Mrs. Logan, she received no taxable income until the amounts received by her exceeded the value at which they were included in the gross estate for Federal Estate taxation, since said payments represented a bequest to her, which is specifically exempted from income tax.

Even if the sale were a closed and completed transaction in 1916, the apportionment of each payment thereafter into capital and income as made by the Board of Tax Appeals and the Commissioner in each year is wrong. The Commissioner's theory contemplates the receipt of fixed sums for a period of 45 years. Such payments would be analogous to annuities, and on that basis the entire cost of the payments must be fully deducted before any part of the payments constitute taxable income, and that principle has been consistently upheld by administrative and judicial determination and finally by statutory enactment. If that principle is not applied to this case, the apportionment of each pay-

ment into income and capital should be made on the same basis on which the present value of the payments is computed. On that basis, the earlier payments represent a larger proportion of capital and a smaller proportion of interest, and as the payments fall in, the capital proportion decreases and the income proportion increases.

ARGUMENT.

I. THE TRANSACTION OF MARCH 11, 1916, WAS A SALE OF STOCK AND NOT AN EXCHANGE OF PROPERTY FOR PROPERTY, SO THAT THERE IS NO TAXABLE GAIN UNTIL THE AGGREGATE PAYMENTS EXCEED THE MARCH 1, 1913, VALUE OF THE STOCK.

Petitioner does not dispute that in the case of a sale of property acquired before March 1, 1913, there is no taxable gain until the payments received exceed the March 1, 1913, value (see pp. 31 and 8 of Petitioner's Brief). Without briefing the point at all, petitioner assumed that this is a case of an "exchange of property for property." The analysis fails at this point, and since the remaining steps are dependent on this premise, they too must fail.

Mrs. Logan transferred stock for part payment in cash plus a contingent promise to make further payments measured by future ore deliveries to be made by the Mahoning Company to the purchaser. That is a *sale* of stock, not an exchange of property. "Sale" as here used implies a monetary consideration and differs from an exchange in that the latter implies a consideration in goods or merchandise susceptible of valuation (Bouvier's Law Dictionary, 3rd ed. "Sale"). Simply because the promise to pay is executory, the transaction is not converted from a sale to an exchange of property.

In the court below, the Government called this promise

"an income-producing contract," and the Sixth Circuit so referred to it and thereby begs the question (*Hitchcock* v. *Commissioner* (C. C. A. 6th), 44 Fed. (2d) 756, 757). The Government tacitly assumes the same position in this court, although the Commissioner formerly denominated it and treated the transaction as a sale (R. 58, 60).

The Board of Tax Appeals has held that similar transactions are sales and not exchanges. *J. H. Johnson, et al.* v. *Commissioner,* 19 B. T. A. 840; *Pinellas Ice and Cold Storage Co.* v. *Commissioner,* 21 B. T. A. 425; *Geary* v. *Commissioner,* 6 B. T. A. 1109.

In determining the gain, if any, on the sale of property, the March 1, 1913, value must be deducted before there is any taxable gain. This is plainly required by the Revenue Act of September 8, 1916 (Sec. 2(c), c. 463, 39 Stat. L. 758):

> "(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

Section 202(a) (1) of the Revenue Act of 1918 is to the same effect (c. 18, 40 Stat. L. 1057) (Appendix).

This court's decisions unanimously hold that there is no taxable gain on the sale of personal property acquired before March 1, 1913, until the amounts received or realized by the vendor exceed the March 1, 1913, value. *Goodrich* v. *Edwards,* 255 U. S. 527, (1921); *Doyle* v. *Mitchell Bros.,* 247 U. S. 179, (1918); see *Burnet, Com'r,* v. *Thompson Oil & Gas Co.,* (U. S.), decided April 13, 1931. The principle is aptly stated in *Lucas* v. *Alexander,* 279 U. S. 573, 580, (1929):

> "* * * For the necessity of ascertaining value as of March 1, 1913, can never arise until some later date

when income has been produced by converting the property into money or money's worth and the amount actually realized is known, and then, as we have said, only for the purpose of apportioning the total gain which has accrued between the periods before and after March 1, 1913."

Cases relied upon by petitioner and the Sixth Circuit as recognizing that deferred installments of purchase price include an element of income are not in point. *Ruth Iron Co.* v. *Commissioner of Internal Revenue* (C. C. A. 8th), 26 Fed. (2d) 30; *Kosmerl* v. *Commissioner of Internal Revenue* (C. C. A. 7th), 25 Fed. (2d) 87; *Platt* v. *Bowers* (S. D. N. Y.), 13 Fed. (2d) 951; *Eldredge* v. *United States* (C. C. A. 6th), 31 Fed. (2d) 924. In all of these cases, the transaction was completed before March 1, 1913, and the question was simply one of returning the March 1, 1913, value of certain rights to future payments, which value the statutes and the Sixteenth Amendment require to be returned as capital before any part of their later conversion into cash can be considered income. These cases do not involve the question of whether there is any gain upon a sale after March 1, 1913, before the March 1, 1913, value of the property sold is returned, nor do they involve the question as to whether a promise to pay at some indefinite future time an indefinite sum of money in consideration for the transfer of stock has a present market value for the determination of gain, before the contingencies occur, which make the promise enforcible, and before the promise is performed.

It is stipulated that the total payments received by the respondent from the sale of her 250 shares of stock, down to and including the year 1920, was less than the March 1, 1913, value of the shares sold (R. 45). It can be seen by a simple mathematical computation how the Commissioner's method deprived the selling stockholders of their rights fixed by statute and decisions of this court to have returned to them the March 1, 1913, value of the shares sold before

taxable gain is realized. The Commissioner determined that the entire 4,000 shares of stock sold had a March 1, 1913, value of more than $4,142,111.46 (Footnote 1). Of this amount, the vendors received $2,200,000 in cash in 1916, as a down payment, and over the period of years to December 31, 1920, $569,436.80 (Footnote 2). The balance of $1,372,674.66, conceded March 1, 1913, value, was not restored up to December 31, 1920. In an ordinary case, gain is computed only when the amount received exceeds the March 1, 1913, value of the property sold and no gain is realized and hence no part of the receipts is taxable until the March 1, 1913, value is exceeded. The fact that some of the payments are spread over a series of years does not render the statute inoperative and cause something less to be restored, to-wit, the supposed present value determined by mathematical formula of these future contingent payments.

Even the Sixth Circuit in the *Hitchcock* opinion stated (44 Fed. (2d) 757):

> "Consequently, if the capital value which petitioner is entitled to have returned is the value of the Andrews Company stock as of March 1, 1913, there is no showing of any tax liability for any of the years here involved."

The Court's error consists in holding that a promise to pay on the contingencies specified in this case is equivalent to a cash payment of $1,900,000 for the stock and that the transaction is thereby closed.

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(1) The Income Tax Unit found the present value of the future payments to be $2,049,018.65 (R. 57). The Committee on Appeals and Review changed this to $1,942,111.46 (R. 46). By adding this present value to the cash payment in 1916, the Bureau found that the total was *less* than the March 1, 1913, value of the stock and there was no gain in 1916 (R. 57).

(2) Mrs. Logan received 250/4000ths of the subsequent payments made, or $35,589.80. The total payments for the 4000 shares was 16 x $35,589.80 or $569,436.80 (R. 45).

II. BEFORE THERE IS ANY TAXABLE GAIN, THE CONSIDERATION MUST BE RECEIVED AND MUST BE CASH OR READILY REDUCIBLE TO CASH.

Mr. Judge Learned Hand in *Bedell* v. *Commissioner of Internal Revenue* (C. C. A. 2nd), 30 Fed. (2d) 622, 624 (1929), has pointed out that a transaction similar to that here involved cannot be treated as a closed and completed transaction until the promise to make the future payments is performed. His statement cannot be abbreviated without destroying the thought:

> "* * * While equity regards a vendee before payment as owner, still the payment is for the title, and is conditional on its delivery, as much as in the case of chattels where title has not passed. Of course, it is true that an obligation, even a conditional obligation, is in some sense property, and, like anything else that can be transferred, may be said to have a value, but nevertheless payment is made in exchange for title, and will never be made if it is not conveyed. To speak of the profit as resulting because its amount can be presently ascertained, though performance remains uncertain, seems to us a perversion of language.
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> * * * * * * *
>
> "While, therefore, we do not think that the case is like a promise to pay in the future for a title which passes at the time of contract, we would not be understood as holding by implication that even in that case the profit is to be reckoned as of the time of sale. If a company sells out its plant for a negotiable bond issue payable in the future, the profit may be determined by the present market value of the bonds. But if land or a chattel is sold, and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title appears to us a strained use of language, when calculating profits under the income tax. Section 202(b) of the Act of 1918 provided for an exchange of property and made

> the profit depend upon 'the amount of its (the property received) fair market value if any'—a phrase which was amended in the law of 1921 (42 Stat. 227) to 'readily realizable market value.' There is a difference between the two, but it is absurd to speak of a promise to pay a sum in the future as having a 'market value,' fair or unfair. Such rights are sold, if at all, only by seeking out a purchaser and higgling with him on the basis of the particular transaction. Even if we could treat the case as an exchange of property, the profit would be realized only when the promise was performed. We agree with the Board upon the first point."

The expectation or prospect of profit does not give rise to a taxable transaction. The gain must be realized. *Lynch* v. *Turrish*, 247 U. S. 221, 230 (1913); *Safe Deposit & Trust Co.* v. *Miles* (Dist. Md.), 273 Fed. 822, 825 (1921); *Weiss* v. *Stearn*, 265 U. S. 242, 252 (1924). This is best stated in *Lucas* v. *American Code Co., Inc.*, 280 U. S. 445, 449 (1930):

> "Generally speaking, the income-tax law is concerned only with realized losses, as with realized gains, Weiss v. Weiner, 279 U. S. 333, 335. * * * The general requirement that losses be deducted in the year in which they are sustained calls for a practical, not a legal, test. * * *"

In the following cases on sales of property, the courts found that the gain, if any, is postponed to the date of realization. *U. S.* v. *Schillinger* (Cir. Ct. S. D. of N. Y.), 14 Blatch. 71 (1876), Fed. Cas. No. 16,228; *U. S.* v. *Christine Oil and Gas Co.* (Dist. Ct. W. D. La.), 269 Fed. 458 (1920); *Bourn* v. *McLaughlin* (Dist. Ct. N. D. Cal.), 19 Fed. (2d) 148 (1927); *Tsivoglou* v. *U. S.*, 27 Fed. (2d) 564 (1928); (Dist. Ct. Mass.) affirmed 31 Fed. (2d) 706.

Here the Commissioner and the Board have spelled out a paper profit which they are attempting to treat as an actual profit in hand for tax purposes. The taxing statutes and

regulations are simply aids in arriving at income, and cannot be used to create income. *Taplin* v. *Commissioner* (C. C. A. 6th, 1930), 41 Fed. (2d) 454, 456.

A taxpayer on the cash basis may not deduct a liability on a note until he pays his note. *Eckert* v. *Commissioner of Internal Revenue* (U. S.), decided April 13, 1931. Neither does it seem that a taxpayer on the cash basis realizes income until a promise to pay him money is performed and exceeds the statutory base of property sold for the promise.

III. THE CONSIDERATION CONSISTING OF A PROMISE TO MAKE PAYMENTS IN THE FUTURE, UNCERTAIN IN AMOUNT, FOR A PRESENT TRANSFER OF STOCK ON MARCH 11, 1916, WAS NOT THE EQUIVALENT OF CASH, AND HENCE, THE TRANSACTION WAS NOT A CLOSED AND COMPLETED TRANSACTION IN 1916.

Petitioner argues that the question whether the property has a fair market value is one of fact, and that the Board of Tax Appeals found that the contract had a determinable market value, and there was no evidence showing that the value determined by the Commissioner was erroneous (Petitioner's Brief, p. 13), entirely overlooking the fact that the court below carefully pointed out in its opinion the many uncertainties involved in the future payments to be made under the contract and affirmatively found that there was ample testimony establishing that there was no market for the sale of the obligation to make future payments (R. 97).

On the facts here, the determination of whether the promise to pay contained in the contract of March 11, 1916, is the equivalent of cash, or had a "fair market value" is primarily one of law. The conclusion which the Board seems to draw is that a promise, merely because it has some value,

can be said to have a "fair market value" or be the equivalent of cash (R. 23, 24). But irrespective of whether the question is one of law or fact, the undisputed facts, supported by the testimony offered before the Board, show conclusively that the Circuit Court of Appeals was right in its ultimate conclusion that the contract could not be deemed to have a fair market value or be considered the equivalent of cash, and that the Board's finding to the contrary was clearly unsupported by the record. The facts and testimony bearing on this question are fully discussed under our next point, and under such circumstances, it is well settled that the Circuit Court of Appeals has power to reverse the determination of the Board. *Ox Fibre Brush Company* v. *Commissioner*, 32 Fed. (2d) 42 (C. C. A. 4th); *Kendrick Coal & Dock Company* v. *Commissioner* (C. C. A. 8th), 29 Fed. (2d) 559; *St. Paul Abstract Company* v. *Commissioner* (C. C. A. 8th), 32 Fed. (2d) 225; *Royal Packing Co.* v. *Comr.* (C. C. A. 9th), 22 F. (2d) 536; *Bishoff* v. *Comr.* (C. C. A. 3rd), 27 F. (2d) 91.

The question is whether any such value can be definitely ascertained to the extent that a taxpayer can be taxed for a profit merely because he is the promisee and taxed on that profit *before* performance. Such a fair market value presupposes that it can be determined with substantial certainty and without undue complexity. Algebraic formulae for determining value are not lightly to be imputed to legislators. *Edwards* v. *Slocum* (C. C. A. 2nd), 287 Fed. 651. When such a formula yelds only a value of 32 per cent of the assumed future payments, it is seriously open to question whether such a promise has an ascertainable market value or is equivalent to cash. A fair and reasonable value is contemplated. *Phillips* v. *U. S.* (W. D. Pa.), 12 Fed. (2d) 598, 601; *Clarke* v. *Welch* (So. D. Cal. 1930), 46 Fed. (2d), 563, 564.

Cash equivalents are and should be limited to things that are readily saleable, or are subject to discount. The Com-

missioner himself has ruled that promises to be evaluated should be evidenced by notes or other transferable medium. *G. C. M. 1387, VI-1 C. B. 48; G. C. M. 3350, VII-1 C. B. 62.* See also *Ruprecht* v. *Commissioner,* 16 B. T. A. 919, affirmed in 39 Fed. (2d) 458 (C. C. A. 5th); *J. H. Johnson* v. *Commissioner,* 19 B. T. A. 840.

One element contemplated in the finding of a "fair market value" for property is a market price ascertained by sales, i.e., the existence of supply and demand as distinguished from the necessity of developing a buyer or seller. *Walter* v. *Duffy* (C. C. A. 3rd), 287 Fed. 41; *Bedell* v. *Commissioner* (C. C. A. 2nd), 30 Fed. (2d) 622). The existence of a so-called intrinsic value is not sufficient to support a fair market value for purposes of computing gain or loss. *Bourn* v. *McLaughlin* (No. D. Cal.), 19 Fed. (2d) 148; *Tsivoglou* v. *U. S.,* 27 Fed. (2d) 564 (Dist. Ct. Mass.), affirmed in 31 Fed. (2d) 706.

The Sixth Circuit in *Hitchcock* v. *Commissioner,* 44 Fed. (2d) 756, 758, attempted to distinguish the two latter cases on the theory that they dealt with values for purposes of gain or loss on property given in exchange. They then say (p. 758):

> "* * * In this case the value was fixed, not to determine gain or loss on the stock but for the purpose of apportioning the earnings from the contract to capital and gain. * * *."

It is obvious that the court is wrong. The very purpose of fixing the present value of the promise to pay was to compute the *gain or loss* in 1916 on the sale. The Commissioner then took this assumed value for the basis of computing income in future payments, contending that as payment was received, a percentage of the original contract was exhausted.

A promise as contingent in nature as this cannot be considered income or the equivalent of money under any

system of accounting. *L. O. 1086, I-1 C. B. 87; Woods* v. *Lewellyn*, (C. C. A. 3rd), 252 Fed. 106; *Morris Poston Coal Co.* v. *Commissioner* (C. C. A. 6th, 1930), 42 Fed. (2d) 620). See *Workman* v. *Commissioner* (C. C. A. 7th), 41 Fed. (2d) 139. A fortiori, it would not give rise to gain to a taxpayer on the cash basis.

IV. THE PROMISE TO PAY IN THIS CASE IS SO CONTINGENT, UNCERTAIN AND INDEFINITE THAT IT CANNOT BE CONSIDERED THE EQUIVALENT OF CASH OR TO HAVE A "FAIR MARKET VALUE," AND THE FINDING OF THE COURT BELOW TO THIS EFFECT IS AMPLY SUPPORTED BY THE CONCEDED FACTS AND THE EVIDENCE.

Neither a maximum or minimum tonnage nor maximum or minimum payment is provided for by the contract of sale. On the contrary, the tonnage to be mined in each year was subject to the determination of the Board of Directors of the Mahoning Ore & Steel Company on April 1 of each year. A minority stockholder obviously could not and would not control the Board of Directors which would subserve the interests of the majority stockholders. The testimony of the former general superintendent of the Mahoning Ore & Steel Company makes this very plain (R. 69). He states (R. 79):

> "* * * I mean, here were a group of men, six of them, all administering, or most of them, as presidents of various steel companies, with all of the ramifications that they involve. Now, they gathered together and said, 'We want this many tons out of there.' I have seen them change their minds two or three times in six months, but it would be pure supposition on my part to try to say what factors determined them in setting that tonnage. * * *"

The stock sold represented but a 12 per cent interest in the Mahoning Company, and the amount of ore to be mined annually was subject at all times to fluctuation, modification, and even possible extinction by the action of the majority holders in the mining company. This is noteworthy from the number of shifts that have occurred in the stockholdings of the operating company since March 11, 1916. In 1916, the stock was held as follows (R. 50):

Republic Iron & Steel Company	6%
Andrews & Hitchcock Iron Company	12%
Certain individuals represented by trustees	12%
Carnegie Steel Company	20%
Cambria Steel Company	50%

The Cambria Steel Company transferred its holdings to the Midvale Steel & Ordnance Company (R. 68). In 1923, the Midvale Company transferred all its holdings to Bethlehem Steel Company. Thus the control is now in the hands of the Bethlehem Steel Company (R. 78). The center of control is constantly shifting. The Youngstown Sheet & Tube Company is a minority stockholder.

It is a matter of common knowledge that in 1916 and at frequent intervals since that time there has been a movement to consolidate the so-called independent steel companies. Every such transfer involves a readjustment of mine operating policy on the basis of the needs and the aggregate mineral resources of the newly formed group. That this was fully appreciated by the President of the Company is shown by his testimony (R. 61):

> "A. * * * I mean the Andrews & Hitchcock Iron Company being a minority stockholder in the Mahoning Ore & Steel Company, I did not think there was any chance of getting a cash value for the property, and did not bring it up, as to its worth. I mean cash value as to its worth."

(R. 62):

> "Q. Did I understand you to say that you did not think there was any chance of getting the cash value of the Mahoning property? A. Yes; I said that. There was no chance of getting the cash value, on account of the minority holdings."

Even the Government witnesses concurred in the statement that the production is dependent on very uncertain factors which cannot be foreseen with any degree of accuracy. For example, their principal witness stated (R. 85):

> "* * * There are other elements more important—economic conditions, especially in the steel industry, and the number of properties operated by the company operating this particular mine also has a very important bearing, together with the terms of the leases as compared with other leases, and the local conditions of this mine; that is, it may be to the operating company's advantage to curtail operations at one mine and increase them at another. * * *"

Their other witnesses testified (R. 89):

> "I am not so certain as to what the probable life of any particular property may have been. That would depend upon the program of the operator."

On such evidence it is difficult to conceive that anything can be reasonably predicted as to the amount, or the certainty, of production, and yet petitioner wishes this Court to concur in the assumption that for a period of 45 years there will be delivered to the Youngstown Company from the Mahoning mine 1,841,300 tons per annum. In point of fact over the period from 1913 to 1926, the annual production varied from a low of 303,000 tons in 1921 to a high of 3,029,865 tons in 1923 (R. 46).

The assumptions on which the Government founds the valuation of this promise to pay for reducing it to a cash

equivalent are not supported by the evidence and are of such a character that they cannot be made the basis for determining gain or loss for income tax purposes.

There were about 1,000 acres of mineral bearing lands under lease by the Mahoning Ore & Steel Company. The Government's estimate was admittedly based on the content of recoverable ore in only 620 acres out of the entire property leased (R. 45). The Government engineer testified that the remaining tracts of approximately 400 acres were *mineral bearing* (R. 87-88).

To base even an intrinsic value on the assumption that there were only 82,858,535 tons of recoverable ore, which covers only 3/5ths of the total mineral bearing land, is plainly unreasonable.

The second assumption made is that the average annual production will be 1,841,300 tons. This seems to be the average for the years 1913 to 1920, inclusive, but the sale occurred in 1916. The estimate that the future production will be 1,841,300 tons per annum upon the basis of past history, no matter what years may have been used, is necessarily based on a prophecy that future history will present substantially the same conditions that occurred in the past. But such a prophecy is plain fiction. The average for the period 1900 to 1913 (R. 77) is approximately 1,100,000 tons, and for the period 1913 to 1926 (R. 46) approximately 1,750,000 tons, an increase of more than fifty per cent. A similar comparison for the entire Lake Superior region shows an increase in an even greater proportion, from an average of 32,500,000 tons to an average of 51,500,000 tons (Crowell & Murray, *The Iron Ores of Lake Superior, 1927*). Yet the Commissioner, in effect, estimates that from 1927 to 1961 the output of the Mahoning Mine will not exceed the average for the thirteen years from 1914 to 1926 by more than about six per cent. In 1871, the production of iron ore in the United States was approximately five million tons. Who, in that year, would

have ventured to predict that forty-five years later, in 1916, it would prove to be seventy-five million tons?

The plan was to produce 3,000,000 tons (R. 78). The Government engineer himself stated that "the production varies very greatly from year to year" (R. 86). In considering the prophecy in 1916, greater credence can hardly be accorded to the testimony of men who visited these properties in 1923 and 1925 and who had no part in fixing the valuation arrived at in this particular case (R. 86, 87), than to that of a general superintendent who was almost daily on the properties for a period of 20 years and knew it infimately from the operating standpoint. He testified that the future production could not be estimated with reasonable certainty (R. 69).

The Commissioner in this very case laid down the following principle (R. 59):

> "It (the fair market value) implies the existence of a public of possible buyers at a fair price. The adjective 'fair' emphasizes the idea of fairness inherent in this conception of market value and excludes any possibility of a construction of the words 'market value' with reference to a market in which, or to circumstances of sale under which, for any reason, a fair price could not be obtained."

But he failed to observe the principle in application.

Before the Board, respondent produced ample evidence showing there was no market in which such a promise to pay could be sold, nor were there any sales of similar agreements or prices established which enabled such agreements to be evaluated. Messrs. Hitchcock, Putnam and Agnew all testified to this effect (R. 61, 64, 75, 76), and the Circuit Court of Appeals termed their evidence "ample" to establish the non-existence of a market. The petitioner's only witnesses, two Government engineers, wholly failed to meet the issue raised by the testimony offered by the respondent. The most that can be said for the testimony of

the Government engineers is that it went to show that mining properties in the Mesaba district had been valued for the purpose of fixing a depletion rate or had been bought and sold at fixed prices and payment made in promissory notes extending over a long term of years (R. 86-90). They did not know of any case where a market value was attempted to be set upon a contract right similar to that involved here (R. 87). Sales of ore properties are not an indication of an existence of market value for a promise to pay such as here involved. In this very sale, a cash equivalent was not even considered by the parties to the sale (R. 61, 62).

The Government's resort to valuation of such a promise to pay by Hoskold's formula indicates the absence of a cash equivalent which is necessary to the computation of gain on sale of the stock. The formula requires (1) that the money be received in equal yearly payments for a fixed number of successive years; (2) that the amount to be received in each year must amount to a certain total sum which is known and fixed beforehand, in this case, the total prophesied receipts of ore payments. In ordinary affairs of men, Hoskold's formula is never used for such purposes. The Treasury regulations have condemned this method of valuation. See *Art. 202, Regs. 69.* It was also rejected by the Board in *Owens Bottle Co.* v. *Commissioner,* 8 B. T. A. 1197, 1217, and by the Circuit Court of Appeals for the Tenth Circuit in *U. S.* v. *Garbutt,* 35 Fed. (2d) 924, 926.

The whole conception of the formula that a sinking fund is set aside for amortization of the capital on which the taxpayer begins was denied by President Hoover in his *"Principles of Mining,"* p. 44:

> "In the practical conduct of mines or mining companies, sinking funds for amortization of capital are never established. In the vast majority of mines of the class under discussion, the ultimate duration of life is unknown, and therefore there is no basis upon which

to formulate such a definite financial policy, even if it were desired."

In any event, facts shown by reliable evidence are preferable to averages based upon assumed probabilities. *Pacific Gas & Electric Co.* v. *San Francisco*, 265 U. S. 403, 406. Nor can present value methods be used by taxing officials in an effort to create a *market value* or cash equivalent where there is none.

> "Taxes are not laid and collected on theory, but on a situation actually existing, as the facts may show that situation to be. Theory is applied in the absence of such facts. The question of taxation is one of fact, and cannot turn on theories or fiction." *Haugh & Keenan Storage & Transfer Co.* v. *Heiner* (Dist. Ct. W. D. Pa.), 20 Fed. (2d), 921, 923.

With a striking inconsistency the Commissioner fixes the rate of interest included in each payment at a rate of 6 per cent, at the same time as he fixes 4 per cent as the reasonable rate of return upon safe investments.

From the tables, it may be determined that the percentage of capital contained on the Bureau's theory in the aggregate deferred payments varies according to the interest factor used, as follows:

(1) 6% with 4% sinking fund.....32.55%
(2) 6% ignoring sinking fund.....34.34% or 105% of (1)
(3) 5% ignoring sinking fund.....38.43% or 118% of (1)
(4) 4% ignoring sinking fund.....46.04% or 141% of (1)

If the two assumptions in regard to interest rates are not grossly inconsistent, they can be reconciled only on the ground that the purchaser would have required a rate higher than the rate on safe, readily marketable securities for one of two reasons—either that the property here involved would not be readily realizable, or that the assump-

tions on which he was acting were fraught with grave uncertainties. Either explanation immediately destroys the validity of the Commissioner's method.

The question at issue is not which of various estimates that might be made is the most reasonable; it is whether in the circumstances any of them can be said to be the equivalent of cash, having in mind that if any property received is to be treated as the equivalent of cash, the first essential is that the amount of cash to which it is equivalent can be substantially approximated.

Adopting the Commissioner's own basis, we submit that the undisputed evidence shows that the computation should more reasonably be as follows:

Total tonnage in mine at March 1, 1913, as estimated by Commissioner in the Mahoning Ore & Steel Company depletion proceedings (R. 46)	88,561,533	tons
Mined from March 1, 1913, to March 11, 1916 (R. 46)	5,439,655	"
Estimated tonnage at March 11, 1916	83,521,878	"
Proportion receivable by Youngstown Sheet & Tube Company, 12% thereof	10,022,625	"
Payments by Youngstown at 60 cents per ton	$6,013,575.00	
Life of mine at March 1, 1913, as estimated by the Commissioner in Mahoning depletion case (R. 46)	40 years	
Expired at March 11, 1916	3 "	
Unexpired at March 11, 1916	37 years	
Average annual instalments to be received, 1/37th of $6,013,575		$162,529.05
Present value of $1 per annum for 37 years at 5%		$16,711.29
Present value of $162,529.05 receivable in equal instalments over 37 years		$2,716,070.09

It will be observed that the final figure exceeds the Commissioner's valuation by nearly forty per cent (actually 39.85%); yet the only changes made are in estimate of tonnage rate of mining to bring the computation into conformity with the Commissioner's conclusions in the Mahoning depletion case, and the change in the discount rate to five per cent, which was the rate adopted and approved of in the *Ruth Iron Company* case, 4 B. T. A. 1151, relied upon by the Board in its opinion.

If it is not conceded that the alternative method is a

more reasonable computation than the Commissioner's, it cannot be denied that it is at least as reasonable; and if two equally reasonable estimates differ by forty per cent, it cannot be claimed that either can represent a market value which is the equivalent of cash. The Commissioner cannot rightfully conclude from the same data that the life of the mine in one case was 45 years from 1916 and in another was 40 years from 1913.

V. THE PROMISE TO MAKE FUTURE PAYMENTS, HAVING NO FAIR MARKET VALUE AND NOT BEING THE EQUIVALENT OF CASH, THE VALUE AT MARCH 1, 1913, OF THE STOCK SOLD IS THE PROPER BASIS FOR MEASURING TAXABLE INCOME, AND THE TAXPAYER IS ENTITLED TO RECOUP THAT VALUE BEFORE THERE IS ANY REALIZATION OF GAIN SUBJECT TO INCOME TAX.

The proposition that Mrs. Logan has no taxable gain as the result of the sale of her stock, if the promise to make future payments had no exchangeable or fair market value in 1916, until the cash payments received offset the statutory basis of the stock sold, is not disputed in this case and has been consistently recognized by the Board of Tax Appeals and the Commissioner (*Art. 1564, Regs. 62*). Art. 46, Regs. 65, states this well:

> "If the obligations have no fair market value, the amount of the initial payment shall be applied against and reduce the basis, as provided in Section 204 and Articles 1591-1603, of the property sold and if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the basis as provided above and the amount realized therefor."

Bourn v. *McLaughlin* (D. Ct. N. D. Cal.), 19 Fed. (2d) 148.

Tsivoglou v. *U. S.*, 27 Fed. (2d) 564 (1928).

Leroy G. Evans v. *Commissioner*, 5 B. T. A. 806, Acq. VI-2 C. B. 2. (Acquiescence means that the decisions are regarded as reliable authority in tax administration.)

Joliet-Norfolk Farm Corp. v. *Commissioner*, 8 B. T. A. 824, Acq. VII-1 C. B. 16.

D. M. Stevenson v. *Commissioner*, 9 B. T. A. 552, Acq. VII-1 C. B. 30.

C. L. Starr v. *Commissioner*, 9 B. T. A. 886, Acq., VII-2 C. B. 38.

John T. Kennedy v. *Commissioner*, 16 B. T. A. 1372.

Woodmar Realty Co. v. *Commissioner*, 17 B. T. A. 88, Acq. IX-1 C. B. 59.

Old Farmer's Oil Co., 12 B. T. A. 203, Acq. VII-2 C. B. 30.

VI. AS TO THE INTEREST IN THE PAYMENTS BEQUEATHED TO MRS. LOGAN, SHE RECEIVED NO TAXABLE INCOME UNTIL THE AMOUNTS RECEIVED BY HER EXCEEDED THE VALUE AT WHICH THEY WERE INCLUDED IN THE GROSS ESTATE FOR FEDERAL ESTATE TAXATION.

Louisa Andrews, at death on March 22, 1917, owned 1100/4000ths of the net payments to be made by the Youngstown Company. She bequeathed 550/4000ths to her daughter, Mrs. Logan. The Government included these 550/4000ths of anticipated payments in the estate of Louisa Andrews at a value of $277,164.50 and levied the estate tax on that basis. Mrs. Logan received up to December 31, 1920, the last year in question, $31,767.59 of these payments, of which the Government is seeking to tax again this time under the income tax laws $21,252.84. Petitioner cannot gracefully accuse the Second Circuit of applying to this part of the case the same principles as in the rest of the case, for

its brief in the Second Circuit fails to show that any sort of distinction was made by the Government counsel between the amounts received by bequest and the amounts received as part of the purchase price of stock sold.

The anticipated payments represent a chose in action belonging to the estate. When they are reduced to possession by the legatee, the amounts simply represent payment of the bequest in cash and are expressly exempted from income tax by Section 213(b) (3) of the Revenue Act of 1918 (February 29, 1919) c. 18, 40 Stat. L. 1065.

> "Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—
> "(b) Does not include the following items, which shall be exempt from taxation under this title:
> "(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);"

The statutory provision expressly exempting bequests has been entirely overlooked both by the Government and the Sixth Circuit. To say that the bequest is recovered in installments, part of which is bequest and part of which is income, is to deny the exemption provided by law its full force and is an attempt by administrative action to impinge upon the statutory exemption. A bequest of a chose in action of $100 to A, which A collects in due course, can hardly be said to be an "income-producing contract," and that A receives $100 otherwise than by bequest. *Irwin* v. *Gavit*, 268 U. S. 161, was not directed to a case of this kind. That case turned on the principle that income does not lose its character simply because it is severed from the principal fund. The court states (p. 167):

> "* * * The money was income in the hands of the trustees, and we know of nothing in the law that prevented its being paid and received as income by the donee."

This part of the instant case is more closely analogous to the situation in *Burnet, Commissioner*, v. *Whitehouse* (decided by this Court on April 13, 1931), which involved the bequest of an annuity directed to be paid irrespective of income received. This Court held that the payments thereunder constituted a bequest and were exempt as such and explained *Irwin* v. *Gavit* as follows:

> "Irwin v. Gavit is not applicable. The bequest to Gavit was to be paid out of income from a definite fund. If that yielded nothing, he got nothing. This court concluded that the gift was of money to be derived from income and to be paid and received as income by the donee. Here the gift did not depend upon income but was a charge upon the whole estate during the life of the legatee to be satisfied like any ordinary bequest."

The payments on account of the 550/4000ths interest, therefore, were clearly payment of the bequest to Mrs. Logan.

In case the payments had been reduced to possession by the executor, they would not have been taxable as income in his hands until the payments received exceeded the value at which the anticipated payments were subjected to estate tax. *Nichols* v. *U. S.*, 64 Ct. Cls. 241; cert. denied, 277 U. S. 584. The Board of Tax Appeals has held repeatedly to the same effect and the Commissioner has acquiesced in its decisions. *McCarthy, Ex'x* v. *Commissioner*, 9 B. T. A. 525, Acq., VII-2 C. B. 26; *Hearn, Adm'x.*, v. *Commissioner*, 9 B. T. A. 1362, Acq. VII-2 C. B. 17; *Nichols, Ex'r.* v. *Commissioner*, 10 B. T. A. 919, Acq. VII-2 C. B. 29, and other cases. The Commissioner has issued rulings to the same effect. *I. T. 1383, I-2 C. B. 157; O. D. 1112, 5 C. B. 55; I. T. 1563, II-1 C. B. 49; G. C. M. 4983, VII-2 C. B. 136.*

See also *Hertzberg et al.* v. *Wisconsin Tax Commission* (1927), 215 N. W. 936, 194 Wis. 126. See a discussion of that case in *G. C. M. 8826, IX-2 C. B. 194, 197.*

The case of *U. S.* v. *Carter* (C. C. A. 5th), 19 Fed. (2d)

121 (1927), goes to the extent of indicating that even the difference between the estimated and actual value of the bequest is not income.

A distributee of the estate stands in no worse position than an executor in this respect, but rather stands in a better, for in addition he has the support of the statute expressly exempting bequests from income tax.

No injustice is done to the United States, for a Federal Estate Tax was paid on the inheritance. On the same inheritance, the Government seeks to collect an income tax, without noting that it had already collected the estate tax. The Government is contending for an analysis that would impose a double tax on the same payments. The collection of the amount inherited was not a "sale or disposition" of the bequest. Adequate provision is made when income tax is paid on the amounts received in excess of the value at which the payments were subjected to estate tax.

VII. EVEN IF THE SALE WAS A CLOSED AND COMPLETED TRANSACTION IN 1916, THE APPORTIONMENT OF EACH PAYMENT THEREAFTER INTO CAPITAL AND INCOME AS MADE BY THE BOARD OF TAX APPEALS AND THE COMMISSIONER IN EACH YEAR IS WRONG.

The Government suggests that it is not clear, in the event this is a closed and completed sale in 1916, that any part of the payments thereafter represent capital returns. This contention overlooks the fact that to obtain these payments the respondent sold her stock. That stock represents the cost of the payments. The amount to be restored is the March 1, 1913, value of that stock, since it was acquired before March 1, 1913. The *present value* at March 11, 1916, is used by the Commissioner and the Board on the theory that this was the amount "invested," and the case was so

briefed and argued below by the Government. The Bureau allowed a return on the theory that the payments were "royalties" and the return of cost thereof "depletion"; (R. 53-55); the Board's opinion followed that thought for a time and then ended by calling it "exhaustion of contract right" (R. 28). The Government is still confused as to what it is returning to the taxpayer and while suggesting that nothing should be allowed, insists that what has been allowed is enough.

If we approach the problem from the assumption made by the Government that $132,573.60 will be received each year by the former stockholders for 45 years, these payments would be analogous to annuities. The Commissioner is not in a position to answer that they are not annuities, for the validity of the Commissioner's "fair market value" depends on his argument that these payments are certain and predictable. The Board itself has recognized this in the subsequent case of *Guaranty Trust Company of New York, Executor*, v. *Commissioner*, 15 B. T. A. 20, 23, 24, in which it stated that the transfer of a leasehold estate for a promise to pay $100,000 annually to Sherry so long as he should live, was similar to the instant case.

On the Commissioner's theory, this is indistinguishable from the purchase of an annuity and consequently the same methods of determining the point at which income is derived and the amount of income in each payment, should be applied.

Up to and including the decision in *Warner* v. *Walsh* (C. C. A. 2nd), 15 Fed. (2d) 367, on November 8, 1926, the tax laws were consistently administered on the basis that before any part of the payments under annuity contracts could be considered income, the entire cost should first be restored. *I. T. 1484, I-2 C. B. 66, 67, I. T. 1363, I-1 C. B. 79; G. C. M: 1022, VI-1 C. B. 12.* Other circuit courts have reached this result even under the earlier acts. *U. S.* v. *Bolster* (C. C. A. 1st), 26 Fed. (2d) 760 (1928); *Allen* v.

Brandeis (C. C. A. 8th), 29 Fed. (2d) 363 (1928); *Continental Illinois Bank & Trust Company* v. *Commissioner* (C. C. A. 7th), 45 Fed. (2d) 345 (1930). The earlier statutes simply required the return of the premium paid without stating how it should be returned. See Section 4 of the Revenue Act of September 8, 1916; Sections 213(b) (2) of the Revenue Acts of 1918, 1921, 1924 (Appendix). In the Revenue Act of 1926 (Section 213(b)(2)), (app'x) the rule that all cost must be restored before any part is taxable was specifically enacted into law and the regulations conformed thereto. *Regs. 69, Art. 72.* The same provision was repeated in the Revenue Act of 1928 (Section 22(b) (2) (app'x), and Regs. 74 thereunder, Art. 82. The later enactment would, under these conditions, seem to be a clarification rather than a change from the earlier statutory provisions. *Oglesby Coal Co.* v. *Commissioner* (C. C. A. 7th), 46 Fed. (2d) 617, 618.

Therefore, from 1916 to 1928, the Treasury Department had consistently applied the principle used in *Warner* v. *Walsh.* In that period of time, a total of eight revenue acts were enacted by Congress, and in no one of these acts was the rule with respect to annuities as heretofore enforced by the Commissioner of Internal Revenue and sanctioned by the courts, changed in any manner. It received specific statutory approval in the Revenue Acts of 1926 and 1928. In *Brewster* v. *Gage*, 280 U. S. 327, 337; 74 L. Ed. 457, 463, this Court stated:

> "The substantial re-enactment in later acts of the provision theretofore construed by the department is persuasive evidence of legislative approval of the regulation (citing cases) * * *."

It is well established that administrative interpretation, long established, is entitled to considerable weight in the construction of statutes. *Downes* v. *Bidwell*, 182 U. S. 244; *St. Paul, Minneapolis Railway Co.* v. *Phelps*, 137 U. S. 528.

The only dissent to this current of authority is that of the Board of Tax Appeals in *Klein* v. *Commissioner*, 6 B. T. A. 617, which in point of time followed the *Warner* case but preceded the others. The case held that each payment represented in part income in the form of interest and part return of cost or capital. The earlier payments contain a larger proportion of capital. As the payments are made the proportion of capital returned decreases and the amount of taxable income increases in accordance with annuity tables. This very method was first applied to the instant case in the first controversy to come before the Board, *Bruce* v. *Commissioner*, 5 B. T. A. 300, 308:

> "The payments to all the stockholders were estimated by the Commissioner to be $132,573.60 annually for 45 years. These payments were reduced to present worth, using a discount of 6 per cent on future payments with a 4 per cent return on sinking fund. It is evident that the present worth of the payment to be received at the end of the first year differs substantially from the present worth of the payment to be received 45 years in the future. It is further evident that the present worth of all the payments is the sum of the present worth of each annual payment, proper adjustment for the sinking fund being made. In determining what portion of the payment represented a return of the 1916 value, the Commissioner has made the allocation between principal and gain as if the present value in 1916 of each of the annual payments to be received was exactly the same. The proper manner in which to determine what portion of the payment is principal is to split up the total 1916 present worth into its component parts and to treat the present value of the first year's payment as a return of principal upon the first 1,841,300 tons (the estimated annual production) mined, the present value of the second year's payment as a return of principal upon the second 1,841,300 tons mined, and similarly each year until the mine becomes exhausted, or the principal is all returned."

The same principle that the earlier payments contain a larger proportion of income was applied in *Ruth Law Company* v. *Commissioner* (C. C. A. 8th), 26 Fed. (2d) 30, and *Kosmerl* v. *Commissioner* (C. C. A. 7th), 25 Fed. (2d) 87, heretofore relied upon by the Government and the Board.

In the instant case, the Board overruled its prior decision in the *Bruce* case on this point and adopted the Commissioner's method. Two members, following the prior decision, dissented.

The only Court decision applying the method used by the Commissioner is *Eldredge* v. *U. S.* (C. C. A. 6th), 31 Fed. (2d) 924. Judge Mack wrote the opinion in both the *Warner* case in the Second Circuit and the opinion in the *Eldredge* case in the Sixth Circuit. He tried to distinguish the *Eldredge* case from the other Circuit Court decisions by stating that the point relating to return of capital was not argued in those cases. Though not argued, the point was certainly necessary to a decision, and though somewhat inartistically, it was presented in the Government's brief both in *U. S.* v. *Bolster* (C. C. A. 1st), and in *Allen* v. *Brandeis* (C. C. A. 8th):

> "The purchase of an annuity involves the payment of such a sum as will be exhausted at the end of a given period if it and its earnings are paid over to the purchaser in stated annual or other installments. Such installments are composed in part of a portion of the principal sum paid and in part of the earnings during the period of the entire remaining sum" (Brandeis brief, p. 13; Bolster brief, p. 8).

The Government did not attempt to take any of these cases up though the *Klein* opinion was outstanding. In fact, as late as 1929, and more than two years after the *Klein* case, the Commissioner published these decisions as authority for administrative purposes. T. D. 4256-7-8; VIII-1 C. B. 243, 246, 247.

Be that as it may, the *Eldredge* case was founded on the

erroneous assumption by Judge Mack that Hoskold's table gives a single value and that it is impracticable to determine the present value of each assumed payment, and so held it was not necessary to choose between *Warner* v. *Walsh* and the *Klein* rule (p. 929):

> "In the instant case the witnesses as to 1913 capital value have relied upon Hoskold's Formula and obtained a single value of the whole series of annual payments; there is no determination of the March 1, 1913 value of each annual payment. * * *"

Hoskold's formula gives a single present value for a series of assumed annual payments but that value is precisely the sum total of the present value of each payment. The table is simply a short cut to the result of a laborious computation. The skein is just as readily unwound as it is wound. The first Board decision so held and the dissenting members followed it. The annuity tables will give the present value of each payment so that the method is not only practicable but fair, since the apportionment corresponds to the interest element. The risk element is covered by the rate of interest selected in making the discount. The method used in the *Eldredge* case is the rule used in determining depletion of mines and has no application to assumed annual payments which do not depend on exhaustion of ore reserves.

In *Commissioner* v. *John C. Moore Corp.* (C. C. A. 2nd), 42 Fed. (2d) 186 (1930), Judge Mack again reviewed all the various rules and suggested a fourth rule. None of them was held material to the decision, however, and so no choice was made. In a case such as the present, the element of uncertainty both as to the amount and duration of the payments not only makes the rule of *Warner* v. *Walsh* the simpler but also the only reliable rule. In the event that rule is not applied, certainly the principle of apportionment used in the *Klein*, *Ruth Iron* and the first Board decision in

the *Bruce* case should be applied rather than the erroneously founded rule of the *Eldredge* case.

CONCLUSION.

Mrs. Logan derived no taxable gain in any year, since the March 1, 1913, value of the stock sold by her had not been restored during the years in question.

The payments received by bequest under her mother's will are specifically exempted by law from income tax, and furthermore, were taxed as capital to the estate, and cannot be again taxed as income to Mrs. Logan, at least until the amount received exceeds the value at the date of death.

The foregoing points should suffice to dispose of this matter and result in an affirmance of the decision of the Second Circuit.

The Government's argument (Petitioner's Brief, p. 24) that this postpones the profit, and that death may intervene, lacks merit, in that, if no profit is derived before death, there should be no tax for a supposed gain. Furthermore, the estimated value of the payments, as in the case of respondent's mother, is taxed by the Government as part of the decedent's estate. The possibility of death before a profit is derived is rather an argument against taxing a citizen on the prospect that he will live and derive a profit.

The alleged liability for taxes asserted against respondent is based not upon cash payments received, although she made her returns upon the basis of cash receipts and disbursements, but upon a statistical computation based as we have shown upon assumptions and prophecies, as to what will happen during a period, extending into the future for forty-five years, all of which the court below rejected.

If the Government's position is accepted by this Court, the payments received on the Government's theory would correspond to annuity payments for forty-five years, acquired at a cost measured by the March 1, 1913, value of the

stock. The cost or base of the payments should be restored before any part constitutes taxable income. This was the administrative and judicial rule up to the *Klein* case. If each payment is held to represent part interest and part capital, then certainly, Mrs. Logan should be allowed to make the division on the same basis as the present value was determined, in accordance with the opinion of the dissenting members of the Board.

The principle laid down by the Circuit Court of Appeals has the great merit of simplicity. It does no injustice to the Government, or the taxpayer. It is not necessary to resolve any of the other and abstruse questions, if respondent is right in her contention that no taxable gain is derived by her, no matter what form the legal analysis of the transaction takes, until she has, in fact and not on paper, recouped the March 1, 1913, value of the stock sold by her, and the value at the date of her mother's death of the right to the payments thereunder.

In view of the foregoing, it is respectfully submitted, that the judgment of the Circuit Court of Appeals for the Second Circuit should be affirmed.

MILLARD F. TOMPKINS,
HERBERT C. SMYTH,
JOHN ENRIETTO,
Attorneys for Respondent.

Of Counsel,
JOHN W. FORD

APPENDIX.

Section 4 of the Revenue Act of 1916 (Sept. 8, 1916) (c. 463, 39 Stat. L. 758):

"Sec. 4. The following income shall be exempt from the provisions of this title:

"* * * The amount received by the insured, as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon the surrender of the contract; * * *."

Section 202(a) (1) of the Revenue Act of 1918 (Feb. 24, 1919) (c. 18, 40 Stat. L. 1057):

"Sec. 202(a). That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

"(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and"

Section 213(b) (2) of the Revenue Act of 1918 (Feb. 29, 1919) (c. 18, 40 Stat. L. 1065), and Section 213(b) (2) of the Revenue Act of 1921 (Nov. 23, 1921) (c. 136, 42 Stat. L. 238):

"Sec. 213. That for the purposes of this title (except as otherwise provided in Section 233) the term 'gross income'—

"(b) Does not include the following items, which shall be exempt from taxation under this title:

"(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;"

Section 213(b) (2) of the Revenue Act of 1924 (June 2, 1924) (c. 234, 43 Stat. L. 267-8):

"Sec. 213(b). The term 'gross income' does not include the following items, which shall be exempt from taxation under this title:

"(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;"

Section 213(b) (2) of the Revenue Act of 1926 (Feb. 26, 1926) (c. 27, 44 Stat. L. 23-4):

"Sec. 213(b). The term 'gross income' does not include the following items, which shall be exempt from taxation under this title:

"(2) Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts) under a life insurance, endowment, or annuity contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid (whether or not paid during the taxable year) then the excess shall be included in gross income. * * *"

Section 22(b) (2) of the Revenue Act of 1928 (May 29, 1928) (c. 852, 45 Stat. L. 797-8):

"Sec. 22(b). Exclusions from gross income.—The following items shall not be included in gross income and shall be exempt from taxation under this title:

"(2) Annuities, etc.—Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts) under a life insurance, endowment, or annuity contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration paid (whether or not paid during the taxable year) then the excess shall be included in gross income. * * *"